APPENDIX

FOMC NOTES - PRF
May 20, 1997

Mr. Chairman:

Since your last meeting, we have had quite a move in dollar-yen.

In domestic operations, unexpectedly-higher tax revenues provided the Desk with the opportunity to set a new record for outstanding temporary operations.

I will first try to explain the movements in dollar-yen and, then, our domestic operations.

As you can see on the first page of charts,

U.S. short-term forward rates first rose and then declined,

returning to levels just below where they traded at the time of your last meeting;

but still well above their levels prior to the Chairman's Humphrey-Hawkins testimony in late February.

German forward rates have declined modestly,
reflecting a continuation of expectations for:

relatively weak growth;

political stalemate on tax and pension reform; and

no change in rates by the Bundesbank for the foreseeable future.

In contrast, Japanese forward rates have been rising since the start of the new fiscal year on April 1st.

This shift in expectations appears to reflect:

an unwinding of the extremely pessimistic market sentiment toward the Japanese economy.

With the traders' skepticism being eroded,

and loud noises from some quarters of the Bank of Japan and the Ministry of Finance that monetary policy will be firmed,

markets -- once again -- are beginning to price in a tightening by the Bank of Japan later this year.

Turning to the <u>second</u> page, as you can see in the first panel,

Consistent with the pattern of short-term expectations:

U.S. bond yields, shown in green, continued to back up in early April,

along with those of Germany and the United Kingdom,

but began to decline with the release of the first quarter Employment Cost Index, at the end of April.

As you can see, U.K. yields, shown in purple, dropped sharply on May 6th with the Chancellor's announcement of a 25 basis point increase in base rates and the granting of operational independence to the Bank of England.

Again in contrast, Japanese 10-year bond yields, in the second panel in red, began sharply rising from the end of April through early May,

reflecting the change in sentiment about the domestic economy; and

accelerating as the Nikkei broke through the 20 thousand level.

In the bottom panel, you can see the sharp decline of the dollar against the yen, depicted in red, beginning on May 6th, and then accelerating quickly.

At the time, most market analysts focused upon the conjunction of:

The relentless verbal intervention by Ministry of Finance officials, throughout the week of May 5th - 9th, seeking to strengthen the yen vs the dollar; and

The Chairman's speech at NYU on the evening of May 8th,
which market participants perceived as implying a decreased likelihood of an increase in U.S. rates at this meeting.

However, among the causes
of this extraordinary exchange-rate movement
I think the back-up in Japanese interest rates, and interest rate expectations, deserves our special attention,

as it triggered an initial unwinding of the infamous
"yen carry trade".

To begin with, it is worth noting,

the relative stability of dollar-mark; depicted in the bottom panel in blue, and

the lack -- so far -- of any apparent knock-on consequences for other U.S. asset markets
from the significant move
in dollar-yen.

Turning to the third page of charts, you can see

The sharp upward movement in the Japanese 10-year bond yield, again depicted in the first panel,

The decline in 10-year differentials with Japan for U.S., German and U.K. bonds since April 1st, in the second panel;&

The percent appreciations of the yen against the dollar, the mark and the pound sterling, also since April 1st, in the third panel.

Taking all this together,

I think that the backup in Japanese rates,
which accelerated from May 6th through the 9th,

Coupled with the downward drift in U.S.
and other long-term rates,

Gave the strong impression that the market may have been passing through the peak in interest-rate differentials between Japan and the rest of the world;

encouraging many of those who had borrowed yen
to finance trades into higher yielding assets
to begin to close out these positions.

So, while the yen strengthened against the dollar,

I think we need to be careful to avoid
a completely "dollar-centric" view of the world;

And need to recognize that the yen strengthened
against a wide range of currencies,
with pressures being felt not only
in the major exchange rates;
but also in emerging markets from the Czech Republic to Thailand, whose currencies came under pressures at the same time.

In all likelihood, this is just the first chapter in the unwinding of leveraged yen financing.

Turning to domestic operations,

As described in detail in our written report,

the Desk faced what seemed, on some days,
to be the Sisyphean task
of injecting ever-larger quantities of reserves
to offset an historic forecast miss
in anticipated tax inflows.

On the fourth page of charts,
in the first panel, you can see:

-- Our original forecast for the Treasury's Fed Balance, as of April 14th,
depicted in the flat, black line at the bottom;

-- Treasury's actual balance,
depicted in the heavy blue line,

-- Our one-day prior forecast in green, and

-- Our same-day forecast, in red.

It's easy to see the gap between
our original forecast and the actual.

But the scale and the slope of the lines
makes it a little harder to appreciate

the significance of the gap between our one-day out forecast,
in green,
and our revision of that forecast the next morning,
in red,

-- which from April 22nd to April 30th, was never less than 2.2 billion and ranged as high as 9 billion.

In the bottom panel, you can see how the Desk responded,

arranging a series of term RPs, until, by April 30th, we had just less than 52 billion [par amount] in outstanding RPs on our books.

On the fifth page of charts,

you can see the daily range and daily effective rate for the Fed Funds market,

For the same period of last year, in the top panel,

And for this year, in the bottom panel.

Looking at the bottom panel for this year,

the five or so instances of high ranges,
were associated with elevated late-day funds rates,

when we either experienced large projection misses,
or when the dealers' propositions
fell short of our objectives.

If you focus on the short red lines
which indicate the daily effective rates,
1997 looks much like 1996:
the weighted-average effective rates
are reasonably close to the target.

However, if one focuses on the <u>difference</u> in the ranges
between 1996 and 1997,
With 1997's wider fluctuations,

one might be tempted to assume (as we initially did)

that our forecast misses in 1997 were larger
and more numerous than in 1996.

But that is not the case:
the misses between our same-day forecast
and the actual Treasury balance
(the difference between the red and the blue lines
on the previous page)
[and actual reserve levels]
were roughly comparable in both years.

Thus, our initial conclusion is that
the market is somewhat more sensitive this year,
compared to last year,
which may be owing to the lower operating balances.

The final page of charts,
presents the same two periods of funds market trading,

depicting daily funds market trading ranges as expressed
in a single, standard deviation around the effective rate.

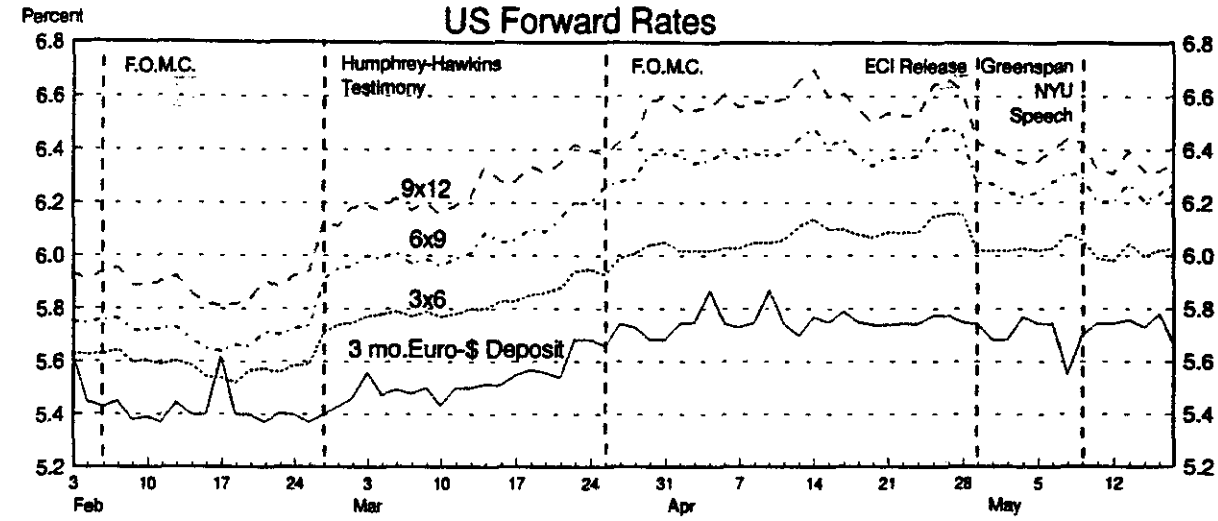
This, in effect, simply presents a more muted version of the range chart, reflecting the relatively limited trading volume at the highest (and lowest) funds rates,

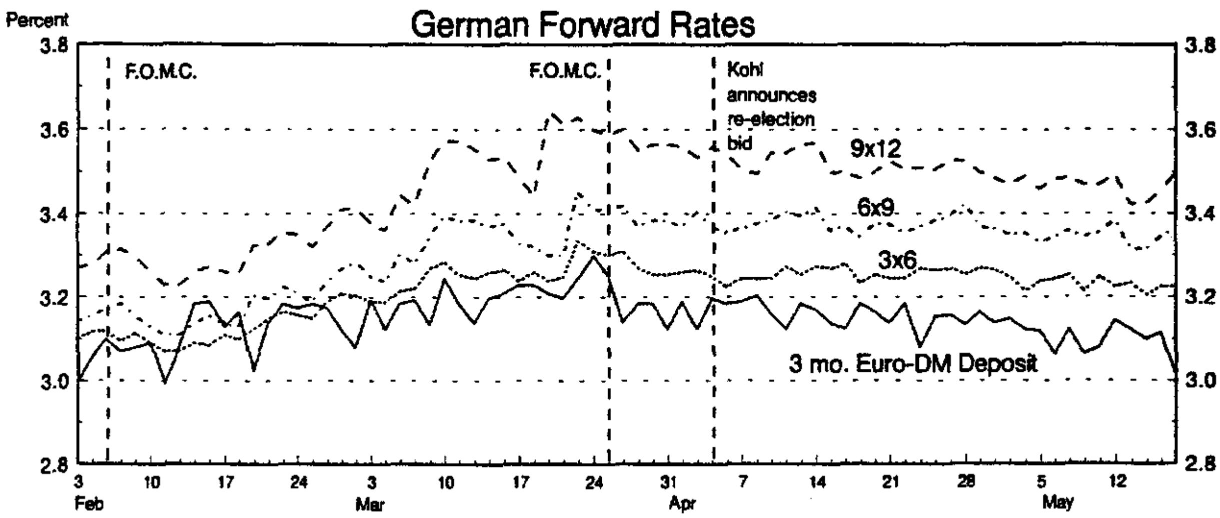
and underscoring the banking system's ability to operate
with low reserve balances.

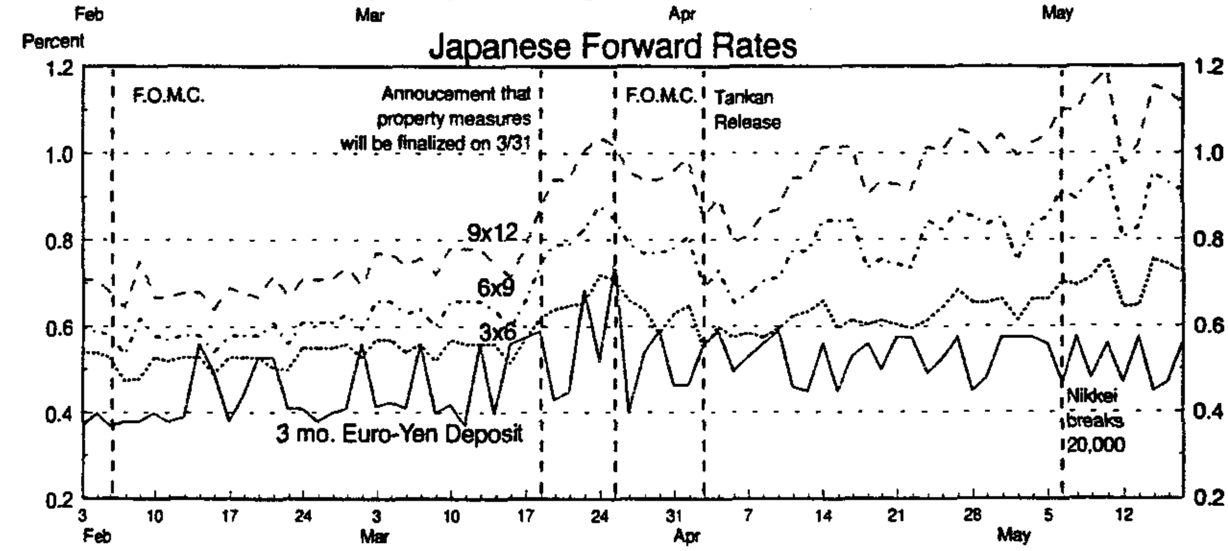
We had no foreign exchange intervention operations during the period.

I will need the Committee's ratification of our domestic operations during the period.

I would be happy to answer any questions
about my report, or my note to the Committee members on my
intention to accelerate our runoff of agency securities.







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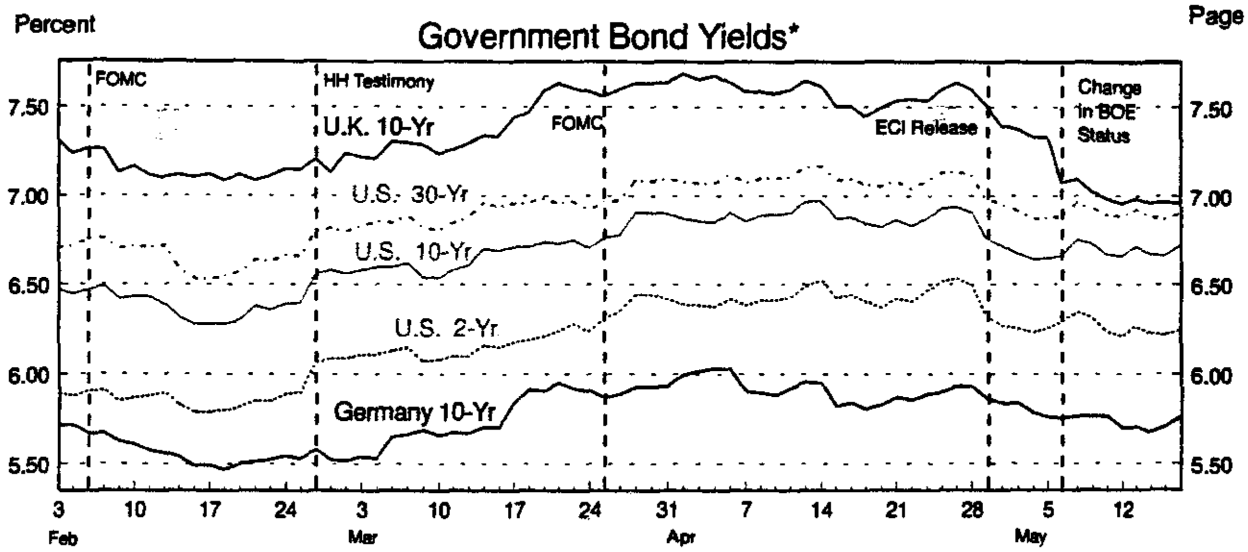
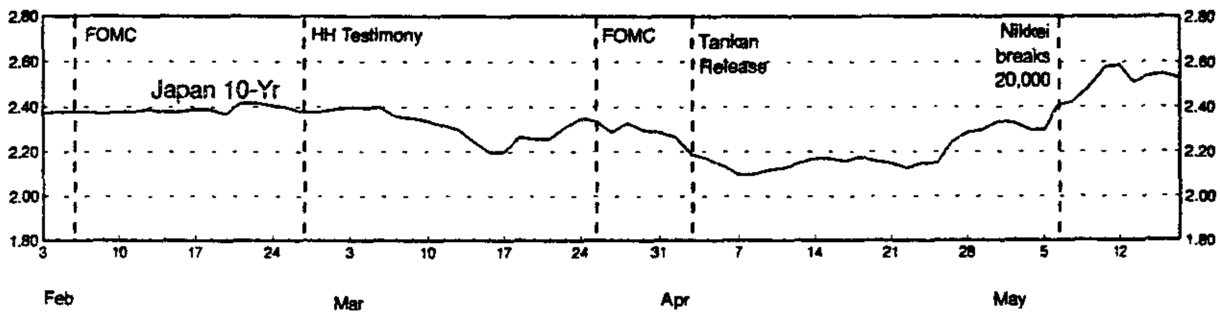
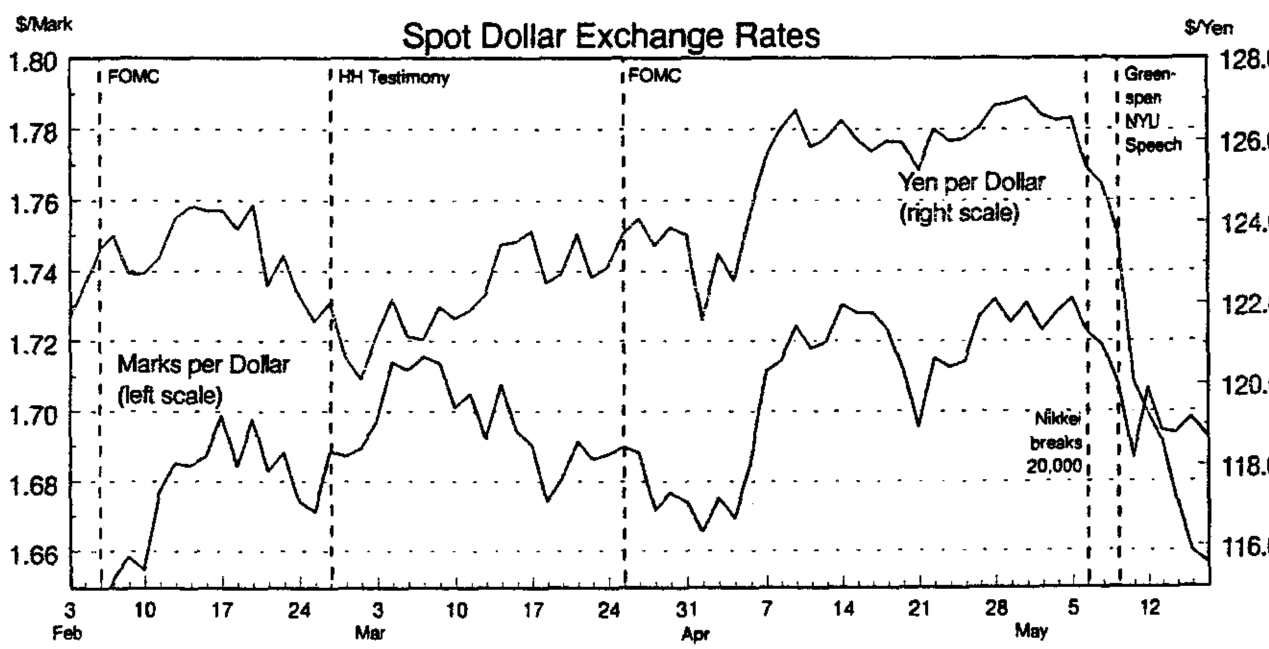
Government Bond Yields*





Source: Bloomberg
*German yields are based on annual coupon payments.

Spot Dollar Exchange Rates



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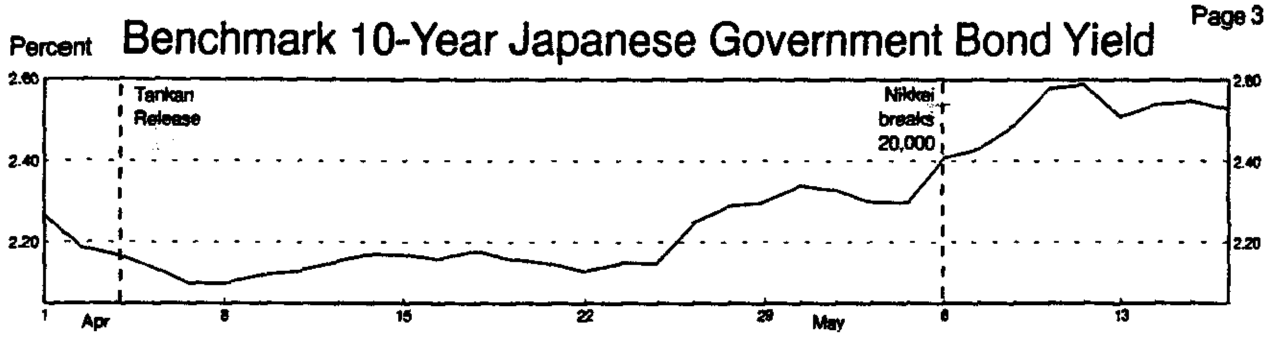

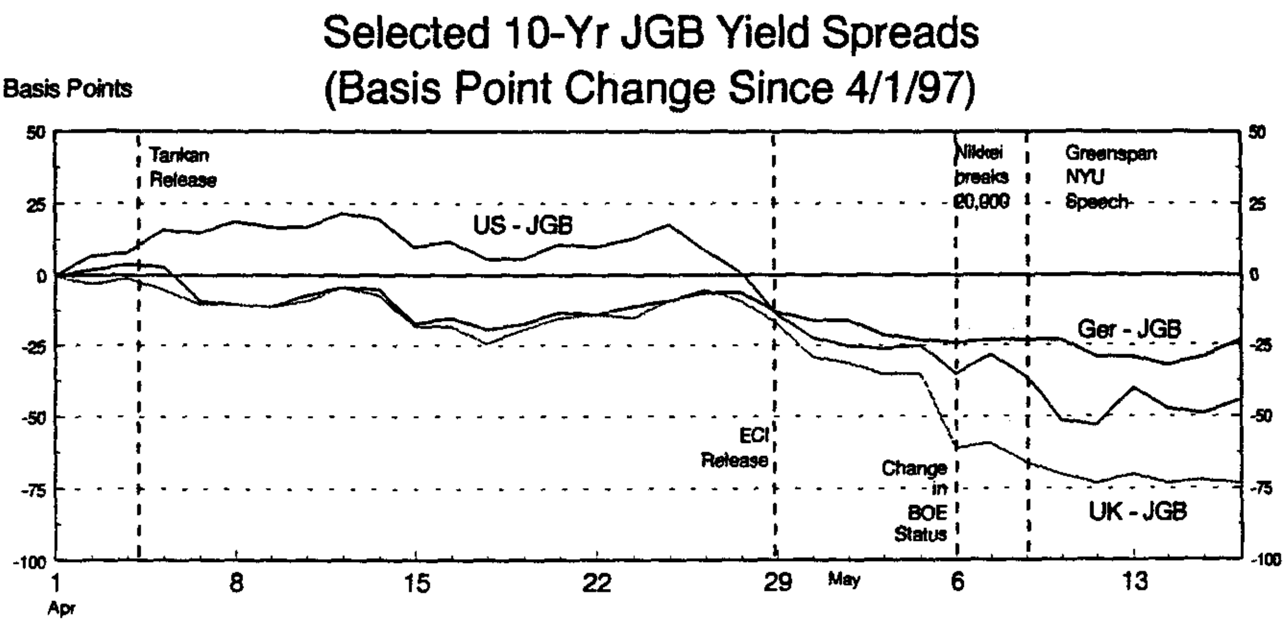

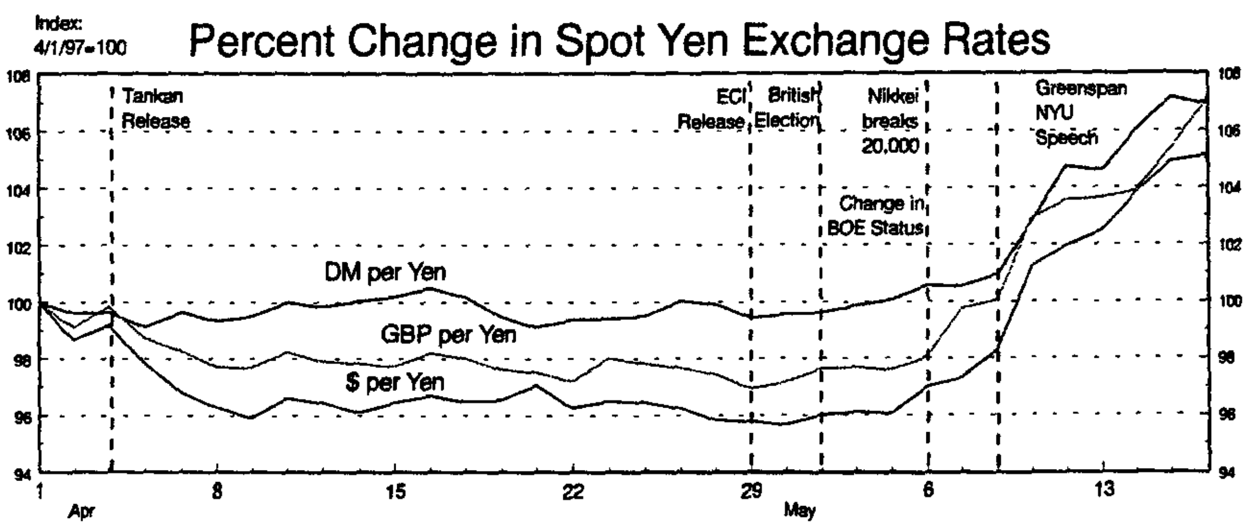

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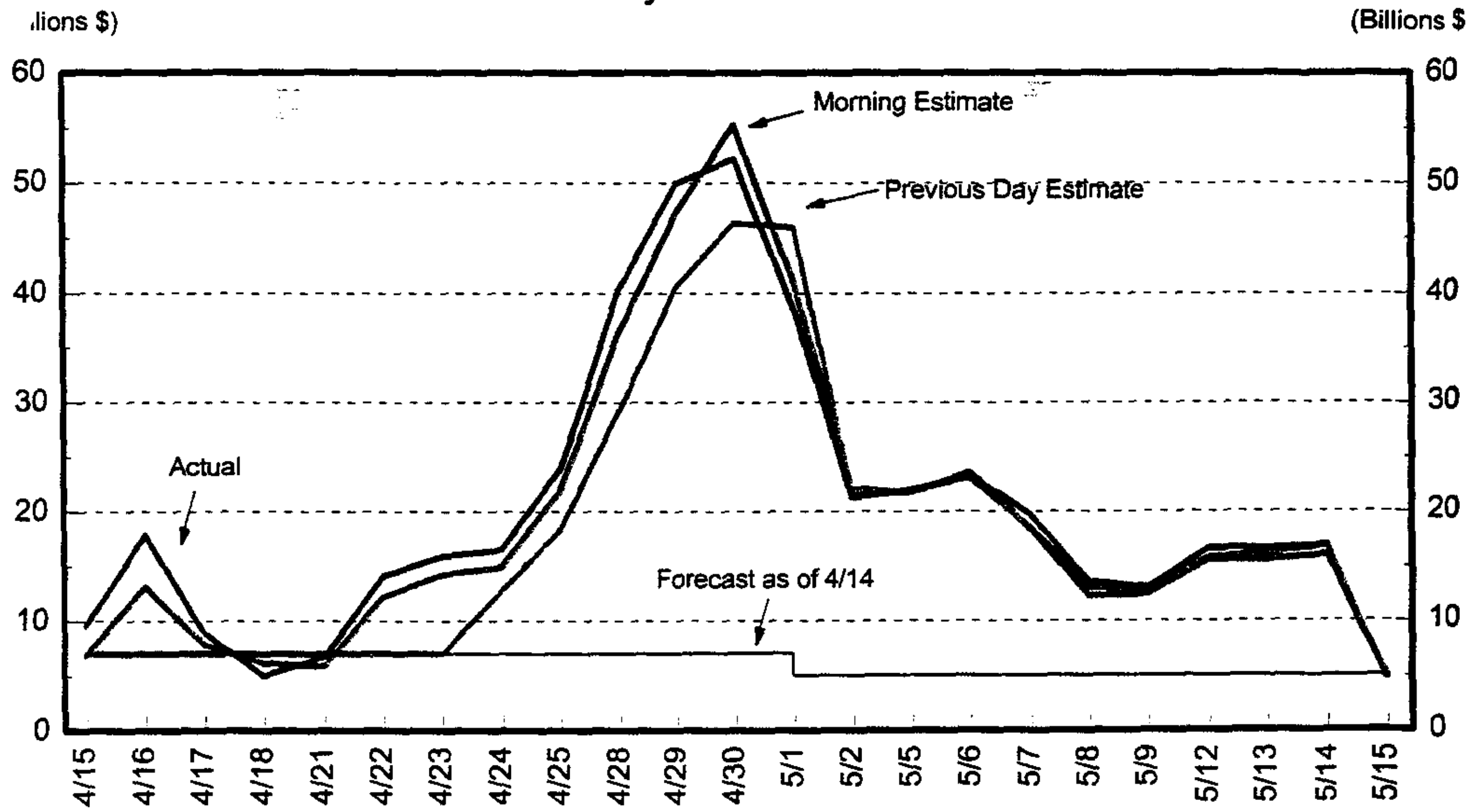
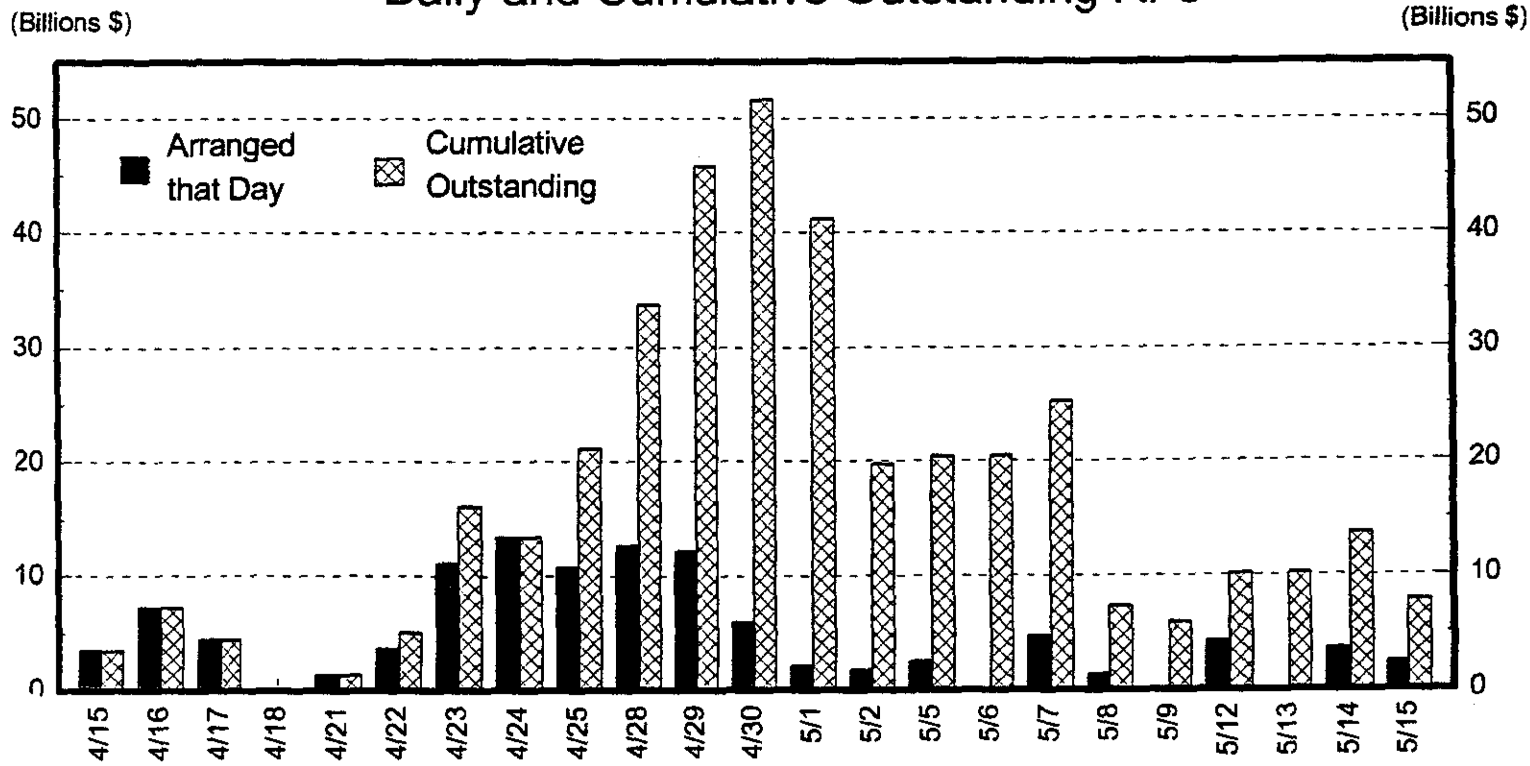
Treasury Balance at Fed



Daily and Cumulative Outstanding RPs



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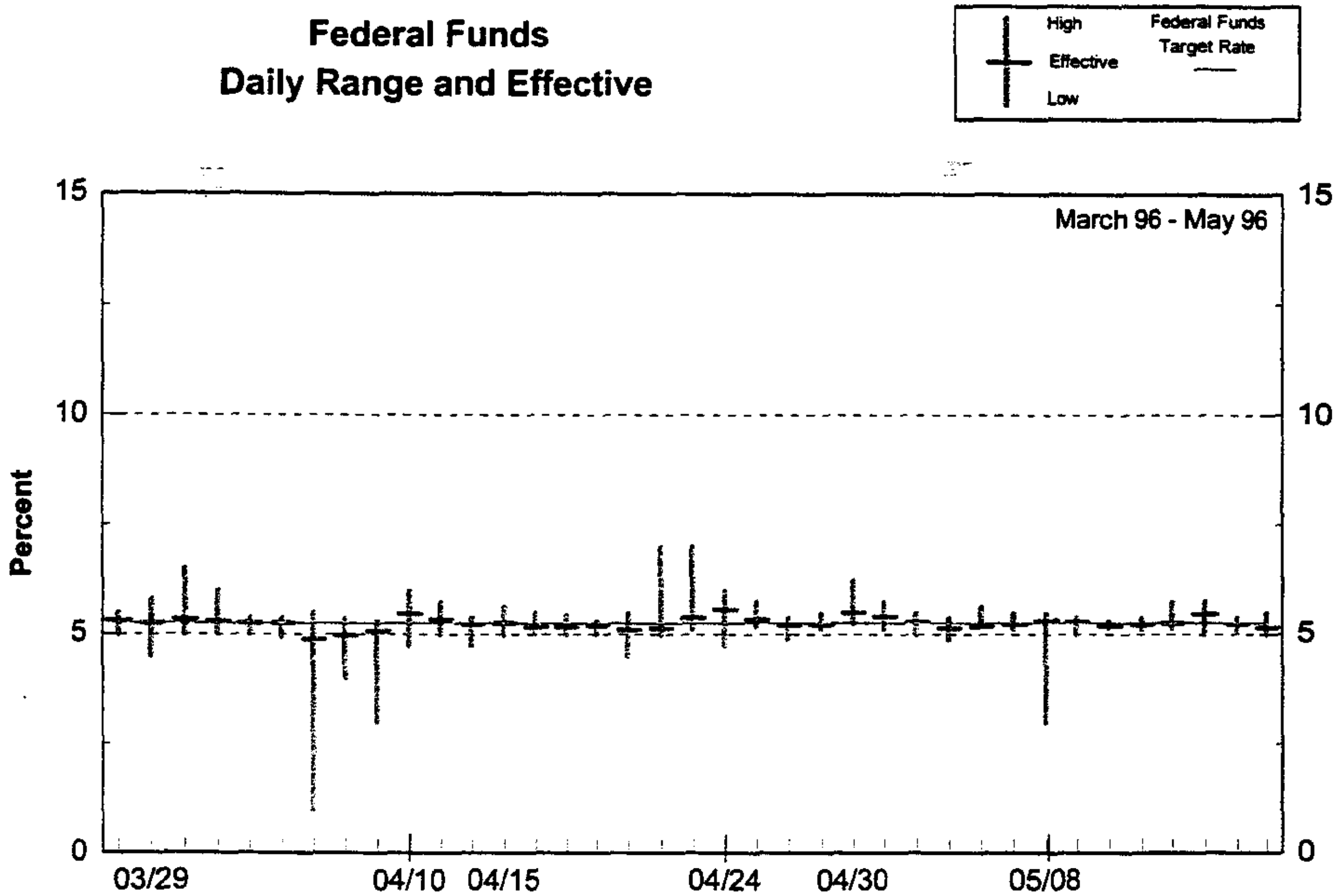
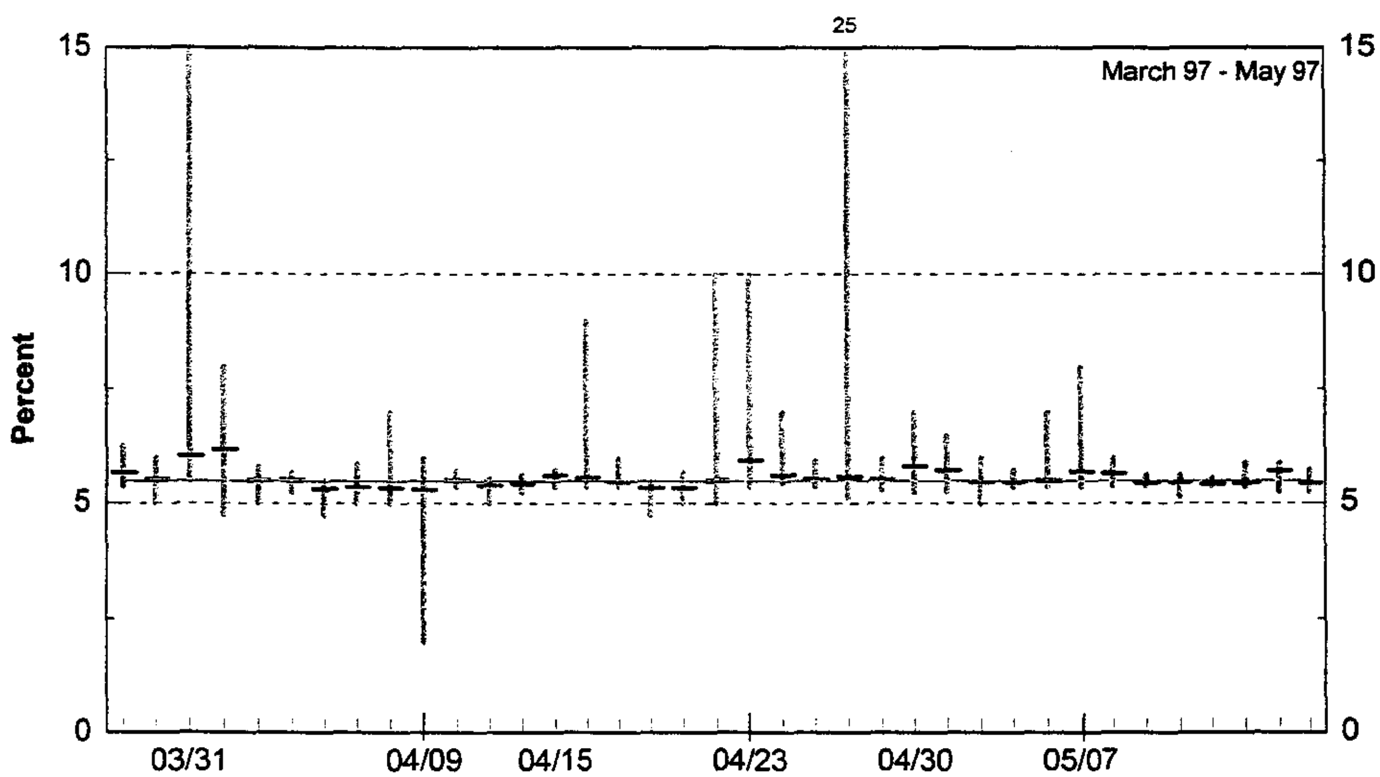
Federal Funds
Daily Range and Effective





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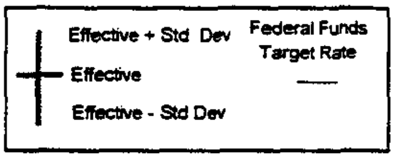
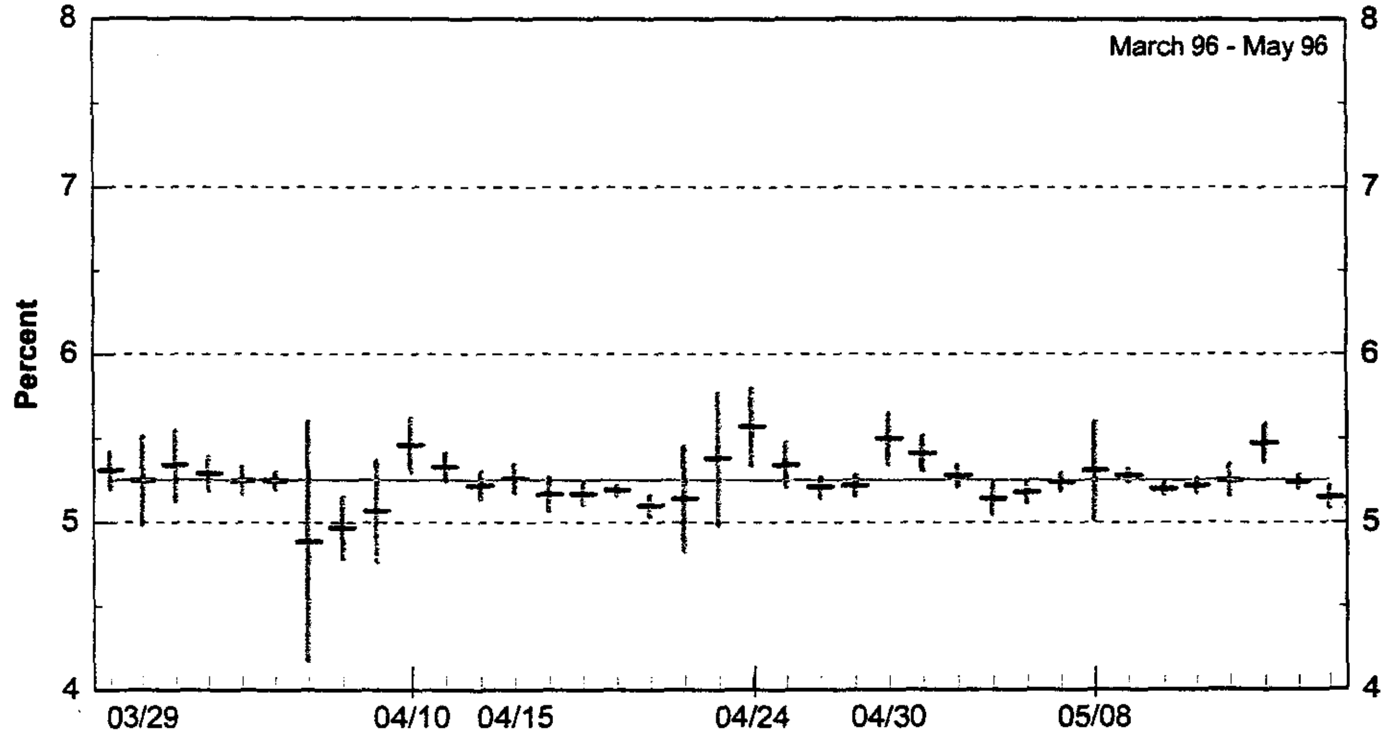
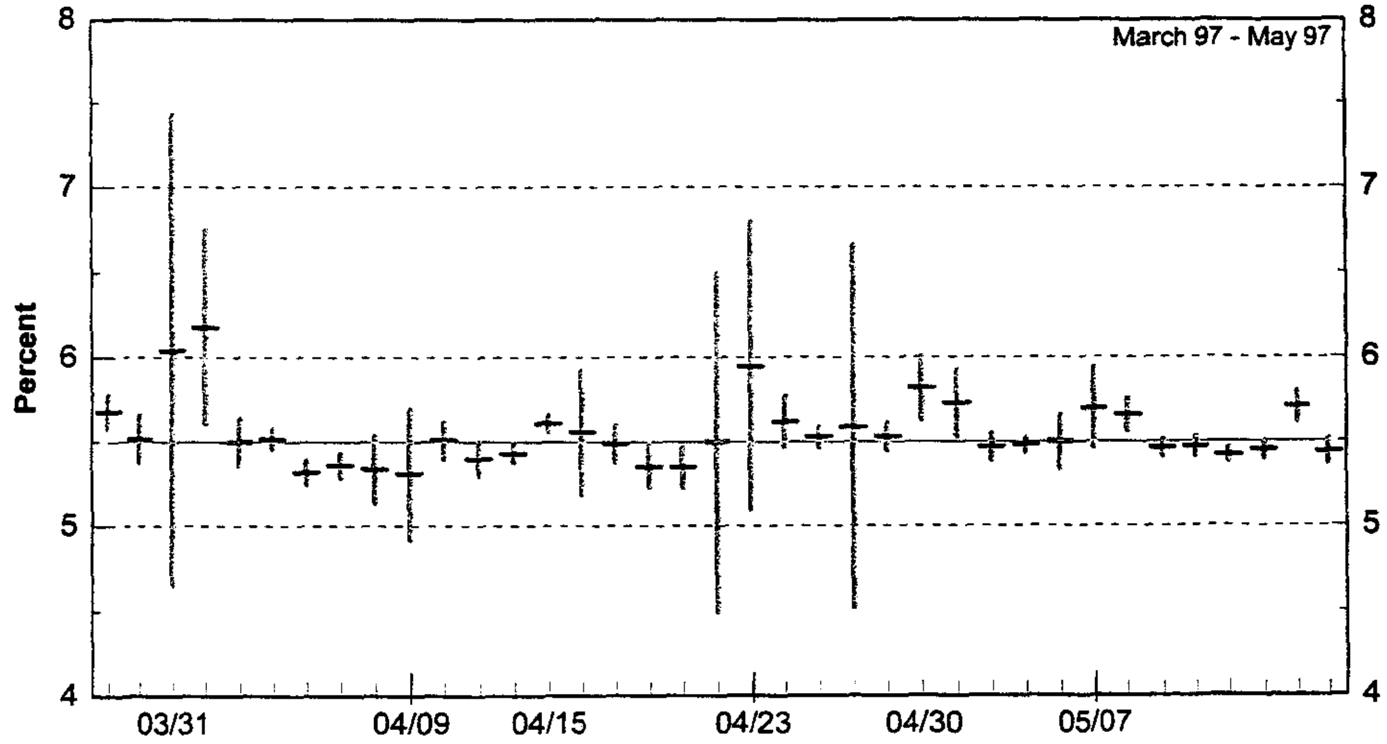
Federal Funds
Plus and Minus
One Standard Deviation and Effective







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